Way Ahead Of Standard Finance (Recent Developments In The Field Of Finance)

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Abstract- As researchers in standard finance assumes that all the decisions are made rationally with an objective of wealth maximisation. As per Mier Statman in reality people act like homo economicus and not homosapiens. Richard father of behavioural finance pointed out that you feel people are clever whereas I feel they are dumb. This paper focuses on a brief overview of how standard finance differs from behavioural finance. It helps to develop an understanding about emerging areas in finance like behavioural finance and neuro finance. This paper shed some light on areas which are not much explored by finding research gaps in the field of behavioural finance.

Introduction

Finance is not something just related to standard finance where investors are assumed to be rational who strives to take optimal decisions. Being Rational they have preference for an option giving more utility than the one offering less utility, they think in logical way and apply reasoning before taking any decision. Traditional finance also assumes markets functions efficiently that's why market price of any security is at par with its intrinsic value and hence investors can't beat the market. While making predictions regarding the future people behave in objective manner and are not biased. It further assumes that via applying modern portfolio theory highest return can be generated for a given risk level or minimum risk for a given level of return. Applying CAPM, arbitrage etc. can help to figure out expected risk and return. It is quite evident in reality that investors don't take their decisions rationally but they tend to commit some errors. These errors are explained in behavioural finance.

Objective of the study- The objective is to study and develop an understanding regarding recent developments in finance i.e. Behavioural finance and neuro finance. As finance is not just confined to standard finance. This study also lays down the difference between behavioural and standards finance.

Methodology and data collection

This research work is descriptive in nature where data is collected from secondary sources like journals, books, newspaper articles etc. So that we can find out which are the gap areas and the biases which are not much focused in past studies.

History of Behavioral finance

Irrationality of investors was identified during merchantilistic phase. Tulip mania also showcase the same. In 1930's and 50's behavioural economics was introduced. Further Cognitive psychology term is coined by Ulrich in 1967. Followed by decision tree approach by Howard Rafilla in 1960. In 1964 Kahneman and Tversky come

up with an important concept of behavioural finance that is prospect theory. Later Kahneman and Riepie figured out that biases are related to judgement, perception or living with consequences of decisions.

Literature review in Behavioral Finance

Loewenstein et al (2001) pointed out that people try to figure out the outputs associated with the decisions that they make and emotion associated with those outcomes. Cognitive evaluations and emotions depends on subjective probabilities, clarity, urgency, mood behind such decision. While forming decisions feelings interact with cognitive evaluation.

John R. Nofsinger (2005) pointed out that optimistic society leads to optimistic consumers, investment and managers. As it leads investors to take risky decisions. As information exchange takes place with communication. Due to this communication spread through word of mouth it is found that managers in same city have same sort of trading. When society have some opinion they affect individual decisions that in turn creates Social trends. Optimism leads people to be more overconfident and hence takes more risk. Paper also explains different phases of social mood cycle starting from increasing mood moving forward to peak positive mood, declining mood and leading to peak negative mood. High social mood leads to high stock market. With the changes in social moods waves get created. The rate of fall in stock market and business activity is quicker than increase in social mood and associated business activity. It is finally concluded in the paper that moods affect the stock market and business activity. People's emotions like happiness or fear, depression affects the market and it isn't other way round.

Meir Statman (2008) figured out that investors are normal and not rational. As rational people have preference for more wealth than less wealth and are not concerned about form of wealth. However normal people want more in comparison to less but that more is not always related to wealth it could be status, social responsibility and they are ready forego wealth so as to increase them. People don't want to realise losses as they suffer from framing and hindsight bias. People also divide their income into mental portfolio of pyramids in behavioural portfolio theory. And also explained behavioural asset pricing model as per which expected returns depends not only on market factor, book-to-market factor, market cap but also on social responsibility, status, momentum, affect and other factors as well. Behavioral finance models describe how people take decisions in actual life.

Saba Amin and Syed S Pirzada (2014) have focussed on behavioural finance with respect to property market. Data for paper is collected from secondary sources. It is found that people decision is not always logical but at times is influenced by available information. And hence investor Land up taking irrational decision. A network diagram is drawn by researcher where Perceptual errors, property market and investment decisions are reflected as dependent variables. Investor's behaviour, personality and psychology along with property market drivers are taken as independent variables. Behavioral finance and market efficiency are taken as moderating Variables. Drivers of property market means factors affecting property market like suuply, demand, affordability, aging population etc. at the end of this paper it is concluded that behavioural factors affects financial decisions.

Vikash Ramiah et. al. (2015) in his paper based on literature review points out that investors could either act rationally based on available information or however those who have irrational reasons to trade are referred to as noise traders. It is found that noise trading have never being studied in relation to sales. Market anomalies might take place due to noise trading. Most of past studies are focussed on conservatism, loss aversion, representativeness, overreaction etc. however less work is done on panic, status quo, and recovery related biases.

Mustafa and Havva (2019) used survey method to collect data from 1002 respondents in Istanbul so as to figure out investment preferences of individual investors. Data was analysed using Factor analysis, t-test, ANOVA, post hoc analysis. Their decision making was found to be affected by psychological biases. However demographic factors affect their investment preferences. When number of alternatives exists leading to difficulty in decision making investors rely more on mental shortcuts. Representativeness is found among the investors who are freelancers are wage workers. Investors with low income, education and middle age are found to be more overconfident. Regret aversion was most evident among middle aged people, although they opted for portfolio diversification but the same was not effective due to lack of self-confidence. Psychological bias were more evident among women.

Cristian Trejos et. al. (2019) studied overconfidence and disposition effect in stock market to study the relationship between overconfidence and disposition. Wherein artificial financial market or micro world is created. For analysis two risky assets are there in capital market those assets do have random returns. Two companies were taken into consideration whose time series data was collected from 2013 till 2017. 77 respondents are taken from Latin America and Europe. Analysis was done using z-tree software. Qualitative confirmatory analysis along with logistic regression are applied. QCA is used to find those factors that lead to overconfidence. These factors are demographics like location, gender, age, level of education etc. and disposition effect. Dichotomous variables i.e. 0,1 are used. Logistic regression was rung between overconfidence and age and it was found that both do have positive relationship but up to some extent i.e. 31 year, post which overconfidence declines. So all below 31 years of age are taken as minors and represented by dummy variable i.e. 1 and 0 if age is more than 31. It was concluded in study that overconfidence depends on education or gender and carrier chosen. However other factors taken in study have insignificant effect on overconfidence. Further studies can be conducted including people from other spheres like businessman, professional etc. This study do have a small sample size further study can be conducted with a larger sample size.

Concept of Behavioral Finance

Behavioral finance is interdisciplinary in nature as its concepts are drawn from sociology, psychology, finance etc. It refers to applying psychology while taking financial decisions. That's why Herbert Simon points out that people search for satisfysing and not optimal solution as rationality is bounded. As we don't do extensive search for all the possible alternatives to solve a problem. Concept of Rational economic man model don't hold true in reality due to constraint imposed by their abilities or available resources at their disposal. Expected utility theory tells ideal way in which people need to behave but prospect theory highlights reality. Where

people are risk seekers for losses and risk averse for gain. Because their emotions or psychology do affect their financial decisions. We don't process all information in our brains like machine but we switch to certain shortcuts to reduce the time required for analysis. These shortcuts are referred to as psychological biases. These biases result in market anomalies.

Pioneers of behavioural finance suggest that if you want to avoid these psychological biases while taking investment decisions then first you need to be aware about those biases. Bias is something that don't allow you to think objectively but take a prejudiced decision. Being biased your decisions might start with hope or fear may end up with regret or pride due to emotional bias.

Hersh Shefrin in his book on "Beyond greed and fear: Understanding behavioral finance and psychology of investing" pointed out that broadly three themes are there in behavioural finance identifying if practitioners do commit errors, next one focus on finding if framing of a problem influence responses and last is to check if market are inefficient or not. At micro level behavioural finance talks about biases among investors however at macro level it focuses on the market that reflects that there are limits to arbitrage.

David Hirshleifer (2001) classified errors done while making investment decisions into four categories. Unable to evaluate situation properly, following trend arising based on available information, inclinations towards emotions and tendency of following society.

So in behavioural finance the focus is on figuring out how psychology operates while taking investment decisions. As people suffers from self-deception and biases also affect them while they process the information. Some of the behavioural biases are listed below. Most of the earlier research work focuses on overconfidence, regret aversion, anchoring, framing etc. Below mentioned are few biases are not very commonly discussed in most of research papers:-

1. Normalcy bias also referred to as ostrich style - It takes place when people believe that everything will continue to be normal no crises will happen. As people either might not have evidenced such crises or they took place far back in their past. So they stop preparing themselves to compete with such crises if they occur. Such bias can be properly dealt with if you start preparing yourself for such crises situations not by just reading content but analysing it as well.
2. False consensus bias- Here people believe that others also believe the way you do. Like if you want to watch a particular movie, then you believe other friends of your group also want to watch that movies. However reality might be different. It could be resolved if we ask other people about their point of view rather than jumping straight away to conclusions.
3. Sunk cost bias - sunk cost refers to historical cost which already invested. As cost is already incurred so decision taken now can't reverse it back. People tend to invest more resources at their disposal to correct their earlier wrong decision. The ideal way is to admit that your decision was wrong. While you buy something you take investment decision further a separate consumption decision also needs to be taken. The amount that you already invested is sunk cost and as per economist it shouldn't impact your

decision to consume good or service. Regret can be associated with doing something or failure to do something but the same should not impact your current decisions. This bias is visible if you misses out on an opportunity to buy a security at low prices. And if bias prevail you will wait until the price comes back to that lower level at which you missed the opportunity of making purchase However if feeling of regret no longer prevails with the passage of time then investor might be ready to purchase same stock even at high price.

4. Choice paralysis- As paralysis unable your body to function properly similarly choice paralysis is when you are presented with many options and hence you find it difficult to choose optimal option due to fear that what happen if you will choose an non optimal solution. To resolve this issue try to scale down the options by figuring out the most similar options so that available options can be reduced down.

Neuro finance

It is an extension to the field of behavioural finance that tries to figure out how individual's behavioural and cognitive biases affect their investment decisions. Neuro finance is where we tries to find out by using some equipment or machines that when any person is required to take decision or solve problems what takes place inside their mind. Means how they proceed ahead in terms of taking decisions. It is just an extension to behavioural finance. Here behaviour is observed through appropriate tools. Neuroimaging is popularly used to align neuro finance to get an insights of how brain actually works. It was found that biological factors also affect decision making. These could be either external or internal influencers. As the decision making is done by brain so using drugs, medicines, doing yoga, changes in life style or exercises etc. Can affect the risk perception and in turn could impact their financial decisions. As anxiety can be treated my medicines that affect risk perception of individuals. If investor is in happy, optimistic or positive frame of mind then he will be willing to take more risk or trade more, similarly sale send positive signals to mind and hence consumer purchases more. Researchers have also found that when there is volatility in market physiological reactions are found to be more among intra-day traders and also among new traders in comparison to their experienced counterparts.

Coates and Hubert (2008) found that testosterone is higher with higher returns and cortisol rises with higher risk perception after analysing group of male traders in reality in London city. Cortisol level is higher with rise in market volatility.

Neuro finance is an emerging area of finance where we try to figure out how hormones, diet alterations, medicines, current or past events affect investors financial decision making. It is costly area of study and most of the study is conducted on students and not professional.

Difference between Neoclassical /standard Finance and Behavioural finance.

1. Neoclassical finance considers investors as rational economic man whereas behavioural finance considers investor are behaviourally biased man.

2. Normative decision making- Neoclassical finance focus on how decision should be taken however behavioural finance sheds light on how they are taken in reality.
3. Decisions are taken based on logical reasoning, after analysing available information however behavioural finance believe investors tend to resort to mental shortcuts also known as heuristics.
4. Neoclassical finance believes investors will choose that option which is optimal one however behavioural finance believes that a person will try to find satisficing solution that may not be the optimal one.
5. Neuro finance is an extension to behavioural finance however there is no such extension in case of neoclassical finance.
6. Miller & Modiglani, Markowitz, Sharpe etc are pioneers of neoclassical finance however Richard Thaler, Daniel Kahneman, Amos Tversky, Robert Shiller etc are pioneers in behavioural finance.
7. Neoclassical finance believes in efficient market hypothesis means price reflect all information however as per behavioural finance markets are irrational as they suffer from technical, calendar or fundamental anomalies.

Conclusion

As only way to cope up with biases is developing an understanding about biases. After developing and understanding further work can be done to explore the unexplored area. Although work is done on behavioural biases but not much is done with respect to normalcy, sunk cost, false consensus and choice paralysis biases so researchers can focus to do their work on these biases in behavioural finance. Research could also be done to find how noise trading is associated with high frequency of trading.
In neuro finance most of work so far is done on students, so more studies can be conducted on professionals, mangers etc.

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